

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM  
STATEMENT OF INVESTMENT POLICY**

**FOR**

**CREDIT ENHANCEMENT PROGRAM**

**~~February 14, 2005~~ June 16, 2006**

*This Policy is effective immediately upon adoption and supersedes all previous Credit Enhancement Program Policies.*

**I. PURPOSE**

This document sets forth the investment policy ("the Policy") for the CalPERS Credit Enhancement Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with the management and oversight of the Program.

**II. STRATEGIC OBJECTIVES**

The primary objective of the Program is to earn fee income through a *zero loss-underwriting standard*. Fees will be generated from [annual commitments](#), [up-front closings](#), [amendments](#), and [waivers](#).

To minimize the incentive to maximize fee income, which could lead to increased risk, no specific rate of return is targeted. Rather, the System expects strict conformity with the Policy and shall let market mechanisms set the pricing of [credit enhancement](#) instruments, which will result in incremental income.

**III. RESPONSIBILITIES**

- A. The **System's Investment Committee** ("the Investment Committee") shall have the following responsibilities and duties:
  - 1. Approving Credit Enhancement Policy, and
  - 2. Reviewing Credit Enhancement Program performance annually with the Staff and the [General Pension Consultant](#).
- B. The **System's Investment Staff** ("the Staff") duties shall include, but are not limited to, the following:

1. Providing a due diligence analysis on each transaction focusing, at a minimum, on the borrower's income, balance sheet, cash flow trends, and transaction structure.
2. Preparing a [Prudence Certificate](#) for each transaction.
3. Reporting to the Investment Committee annually about the performance and compliance of the Program.
- ~~4. Monitoring Service Agent's compliance with the Policy on an ongoing basis and following the violation procedures if a violation occurs.~~
- ~~5.4. Reviewing the Policy annually with the Service Agent and recommending changes, if any, to the Investment Committee.~~
- ~~6. Reviewing and evaluating the portfolio and quarterly reports from the Service Agent; and designing and requesting changes to the portfolio and quarterly report formats as needed.~~
- ~~7.5. Reporting immediately all Policy violations to the [Chief Investment Officer](#) (CIO) and the Investment Committee at the next Board meeting with explanations and a plan of action to prudently remedy such a violation.~~

#### IV. ~~SERVICE AGENT REQUIREMENTS~~

- A. ~~The Program shall have a [Service Agent](#).~~
- B. ~~Such a Service Agent, or its successor, shall have the following minimum qualifications:~~
  - ~~1. Must be a financial institution with substantial total net assets of an amount determined to be appropriate at the time of solicitation and maintained throughout the engagement;~~
  - ~~2. Must have a minimum credit rating of single A from at least two of three nationally recognized credit rating agencies (Moody's Investor Service, Standard and Poor's, and Fitch Ratings) that shall be maintained throughout the engagement, and have sufficient risk controls in place to receive a favorable SAS 70 Audit Report;~~
  - ~~3. Must have provided municipal finance for a minimum of ten years;~~
  - ~~4. Must have underwritten letters of credit for a minimum of ten years;~~
  - ~~5. Must have provided letters of credit back office services for its own account or for clients for a minimum of ten years;~~

6. ~~Must have substantial minimum credit enhancement portfolio (letters of credit and lines of credit combined) of an appropriate amount to be determined at the time of solicitation, and maintained throughout the engagement;~~
7. ~~Must have the ability to pre-fund any draw on behalf of the Program for one (1) business day; and~~
8. ~~Must have the willingness and ability to enter into a Risk Participation Agreement with the Program by participating in selected approved credit enhancement transactions, at a minimum of an equal amount of investment, with the Program.~~
9. ~~Participation in a number of transactions is contemplated with other deal-originating or non-originating financial institution(s) through the use of a Risk Participation Agreement. Should the Service Agent not participate, other deal originating financial institution(s) will participate as a fiduciary.~~

- G. ~~The Service Agent must certify annually in writing that it meets the Service Agent requirements.~~
- D. ~~The tenure and review of the Service Agent contract shall be specified under the contract for the Program.~~
- E. ~~The Service Agent shall perform all such services as specified under the contract for the Program.~~
- F. ~~The Service Agent must adhere to the Policy.~~
- G. ~~The Service Agent shall immediately notify Staff on any violation of the Policy.~~
- H. ~~The Service Agent shall provide daily and quarterly reports to include, but are not limited to, the following information:~~

1. ~~A Statement of Compliance with the Policy, noting any securities in the Program portfolio that encountered rating action.~~
2. ~~A Portfolio Report posted electronically and available on a 24-hour basis that will provide detailed analysis of each of the System's credit enhancement exposures and its compliance with the Policy. The Portfolio Report will be in a database format that can allow Staff and other authorized persons to query the report and create custom reports as needed.~~

~~A Credit Market Indicator Report (CMI Report) on a quarterly basis that will provide the Service Agent's assessment of current conditions in the U.S. municipal market including credit and non-credit trends, economic outlook, pricing factors, competition, new~~

~~security pledges, issuance volume, and other factors deemed appropriate.~~

## **~~V. DEAL ORIGINATOR REQUIREMENTS~~**

~~A. The Program shall enter into Strategic Relationships with other financial institutions (“Deal Originators”) to create a broader and diverse deal sourcing and co-investment capability.~~

~~B. Such Deal Originators, or their successors, shall have the following minimum qualifications:~~

- ~~1. Must be a financial institution with substantial total net assets of an amount determined to be appropriate at the time of solicitation and maintained throughout the engagement;~~
- ~~2. Must have a minimum credit rating of double-AA from at least two of three nationally-recognized credit rating agencies (Moody’s Investor Service, Standard and Poor’s, and Fitch Ratings) that shall be maintained throughout the engagement;~~
- ~~3. Must have provided municipal finance for a minimum of five years;~~
- ~~4. Must have underwritten letters of credit for a minimum of five years;~~
- ~~5. Must have substantial minimum credit enhancement portfolio (letters of credit and lines of credit combined) of an appropriate amount to be determined at the time of origination, and maintained throughout the engagement;~~
- ~~6. Must have the willingness and ability to enter into a Risk Participation Agreement with the Program by participating in selected approved credit enhancement transactions, at a minimum of an equal amount of investment, with the Program.~~

~~C. The Deal Originator shall perform all such services as specified under the Deal Originator contract and must certify annually in writing that it meets the Deal Originator requirements.~~

~~D. The Deal Originator must adhere to the Policy and shall immediately notify Staff on any violation of the Policy.~~

~~Upon request by Staff, the Deal Originator shall provide daily and quarterly reports to include, but are not limited to, the following information:~~

- ~~1. A Statement of Compliance with the Policy, noting any securities in the Program portfolio that encountered rating action.~~

2. ~~A Portfolio Report that will provide detailed analysis of each of the System's credit enhancement exposures and its compliance with the Policy. The Portfolio Report will be in a database format that can allow Staff and other authorized persons to query the report and create custom reports as needed.~~

~~A Credit Market Indicator Report (CMI Report) on a quarterly basis that will provide the Deal originator's assessment of current conditions in the U.S. municipal market including credit and non-credit trends, economic outlook, pricing factors, competition, new security pledges, issuance volume, and other factors deemed appropriate.~~

#### **IV.VI. DELEGATIONS**

Staff may, subject to an analysis, documentation and fulfillment of the fiduciary responsibility, and upon approval from the [Senior Investment Officer \(SIO\), Fixed Income](#) Unit and the Chief Investment Officer (CIO), revise the following areas:

- 1.A. Permissible sectors; and
- 2.B. Portfolio average maturity and term to maturity limits.

#### **V.VII. GENERAL**

- A. Computations and calculations shall be based upon the total aggregate amount of \$5 billion committed to the Program.
- B. The "[primary obligor](#)" shall be used in computing geographic distribution limits, direct State government issued [debt limits](#) and municipal market sector limits.
- C. For any [issuer](#) which is a public agency employer for purposes of participation in CalPERS credit enhancement program or entity that might become a public agency employer, a written opinion of counsel for issuer is required that either:
  1. Issuer's securities are exempt pursuant to Section 3(a)(2) of the Securities Act of 1933 (as [security](#) issued by a state or any political subdivision of a state or by any public instrumentality of a state or any political subdivision thereof); or
  2. Issuer's securities are exempt pursuant to section 3(a)(4) of the Securities Act of 1933 (the 501(c)(3) exemption).

## VI.VIII. CREDIT APPROVAL POLICY AND PROCEDURES

### A. Instruments eligible for credit enhancement:

1. [Letters of Credit](#) – These are [irrevocable](#) instruments used to provide credit and liquidity on [variable](#) or fixed rate [note](#) and [bond](#) transactions. The legal obligation to fund under these instruments is **unconditional**. CalPERS' understands that Letters of Credit are irrevocable draws by the [Trustee](#) and will be funded according to the established Funding Procedures.
2. [Lines of Credit](#) – These are also referred to as [Standby Bond or Note Purchase Agreements](#) and [Liquidity Lines](#). These are designed to provide liquidity (as opposed to credit enhancement) in the event of financial market disruption. The legal obligation to fund under these instruments is **conditional**. These are also referred to as revocable instruments.

### B. Exclusions:

1. CalPERS will not provide direct funded loans.
2. The Program will not consider transactions with municipal issuers or conduit issuers on their behalf (obligors) that have [defaulted](#) on any debt (private or public) or declared bankruptcy in the last fifteen years.
3. The Program will not consider [Certificates of Participations \(COPs\)](#) other than those transactions for [Essential Municipal Services](#) (for example, court houses, police and fire stations, water/sewer, and municipal buildings).

### C. Credit [Ratings](#):

1. All issuers under the Program shall be rated [investment grade](#) by at least two [nationally-recognized credit rating agencies](#) ([Moody's](#), [Investors Service](#), [Standard and Poor's](#) and [Fitch Ratings](#)) and any outstanding rating must be investment grade by at least two nationally-recognized credit rating agencies. In addition, such an issuer would not have been rated in the non-investment grade category by any nationally-recognized credit rating agencies at any time within the last five years.
2. If an issuer is not initially rated, ~~the Service Agent shall procure an independent~~ [Rating Category Determination \(RCD\) letter](#) ~~shall be procured~~ from at least two nationally-recognized credit rating agencies. The RCD will provide a determination as to whether a proposed transaction is of investment grade quality.

## D. Credit Rating Portfolio Limits:

1. The average credit quality of the Program's portfolio shall be "single-A" long-term [credit rating](#) designation (A2 by Moody's, A by Standard and Poor's and A by Fitch. See Appendix I for equivalent ratings by Moody's, Standard and Poor's and Fitch).
2. Where a credit transaction has a [split rating](#), i.e. BBB+/A- from two or more credit rating agencies, the Staff ~~and the Service Agent~~ shall use the lower rating for purposes of calculating the average credit quality of the Program's portfolio.

## E. Portfolio Average Maturity

1. The weighted average maturity of the Program's portfolio shall not exceed 5 years.

## F. Portfolio Diversification

## 1. Geographic Distribution

- a. *Philosophy:* Municipalities in ten States – **California, New York, Florida, New Jersey, Texas, Pennsylvania, Illinois, Massachusetts, Michigan** and **Ohio** -- have the largest municipal issuance volume and have consistently been in the "top-ten" States for municipal issuance for at least the last ten years. Since geographic diversification does not significantly reduce risk, and issuance volume is directly correlated to population and opportunities, the Program's portfolio will be aligned with States having the largest population.
- b. *Implementation:* Although geographic distribution is less of a concern from a risk standpoint, Staff will construct a credit enhancement portfolio, on an aggregate dollar total, that will be distributed on a parallel basis to municipal issuance across the entire market with limitations as shown in the Table 1 below.

2. [Direct State Government Issued Debt](#) Limits

- a. *Philosophy:* The overall mission of the Program is to earn fee income on an expected zero loss-underwriting basis by supporting municipal infrastructure development throughout the United States. As such, the Program envisions the majority of primary obligors to be municipalities; not state governments.

- b. *Implementation:* To further control risks and increase portfolio diversification, Direct State Government Issued Debt (voter or non-voter approved) shall not exceed 40% of the Total Aggregate Program Portfolio within a particular State. For example, Direct State Government Issued Debt in California shall not exceed 18% (or 45% x 40%) of the Total Aggregate Program Portfolio as shown in Table 1 below.

**Table 1: State Geographic Distribution and Debt Limits**

State Geographic Distribution	Percentage of Aggregate Program Portfolio	Direct State Government Issued Debt Limits
California	Not to exceed 45%	Not to exceed 18%
New York	Not to exceed 35%	Not to exceed 14%
Florida	Not to exceed 30%	Not to exceed 12%
All Other States*	Not to exceed 20%	Not to exceed 8%

\* Includes the other 47 states and US Territories & Possessions (Guam, Midway Islands, Puerto Rico, US Virgin Islands and Wake Islands)

### 3. Municipal Sector Limits

- a. *Philosophy:* Risk minimization is the desired objective of the Program. As such, only those entities rated investment grade within the traditional municipal sectors that are secured by revenues from the particular entity or back-stopped by the taxing [authority](#) of the municipality; and which have demonstrated low default rates will be eligible for the Program's enhancement.
- b. *Implementation:* To further control risks and strengthen portfolio diversification objectives, the Program's portfolio exposure within each State shall be diversified by transactions in different municipal market sectors. Accordingly, all of the issuers within the portfolio shall come from one of the outlined governmental and public sectors below (including [non-profit 501\(c\)\(3\) institutions](#)) that comprise the U.S. municipal market.



Table 2: Municipal Sector Limits

Sector Nos.	Market Sectors	Percentage of Total Aggregate Program Portfolio
1	<a href="#">General Obligation</a> /Short Term General Fund/Cash Flow Notes	Not to Exceed 100%
2	Public Infrastructure, Facilities and Equipment	Not to Exceed 80%
3	Transportation and Highway	Not to Exceed 70%
4	Water and Waste Water	Not to Exceed 70%
5	Education	Not to Exceed 60%
<b>Sectors Below Shall Not Exceed 50% of Total Aggregate Program Portfolio</b>		
6	Municipal Utility Systems	Not to Exceed 50%
7	Airport and Marine Ports	Not to Exceed 40%
8	Student Loan and Pooled Loan Programs	Not to Exceed 30%
9	Housing	Not to Exceed 25%
10	Securitization Programs	Not to Exceed 15%
11	Public-Supported Stadiums/Arenas	Not to Exceed 15%
12	Solid Waste Facilities/Resource Recovery/Environmental	Not to Exceed 10%
13	Healthcare	Not to Exceed 10%
14	Other*	Not to Exceed 10%

\* This category is established for exceptions to the Policy. It is desirable to respond to changing market conditions and to take advantage of key opportunities that would not specifically fit into the Policy. For example, it may include municipal transactions that have been structured to an investment grade level for an underlying issuer with a non-investment grade rating or for new transactions not contemplated in the Policy (for example, public-purpose not-for-profit organizations, tender options, and [industrial developments](#) with municipal support).

#### 4. [Special Assessment Districts](#)

- a. *Philosophy:* Some studies have generally categorized Special Assessment Districts as having a higher default profile in the [municipal bond](#) market.
- b. *Implementation:* Accordingly, the Program shall only consider such tax allocation/[special assessment bonds](#) with the following characteristics:
  - i) The location is within the geographic region or city limit of a substantial, investment grade rated entity with an identifiable level of past and likely future growth and demand for housing and related infrastructure;
  - ii) The District is not a “start-up”, with at least five years of existing track record and debt servicing record;
  - iii) Raw land sales have been steady or increasingly strong due to demographic demand and population growth; and

- iv) The developer or sponsor is of investment grade quality with excellent debt repayment history and strong construction/management experience.

G. Program Transaction Limits

- 1. The maximum single risk limit per transaction shall be \$250 million.
- 2. The maximum holding in any given transaction in California shall be 25% of the issue in order to be in compliance with the [Safe Harbor rules](#) established under Section 503(e) of the Internal Revenue Code (IRC). Outside California, the maximum holding in any given transaction shall be 50% of the issue.

H. Program Partnerships

- 1. The Program, shall co-invest with at least one [Financial Partner](#) on each transaction; the Financial Partner(s) shall contribute to a sizeable interest on the transaction.

**VII.IX. VIOLATION REPORTING**

A. The violation reporting process shall be as follows:

- ~~1.~~ The Service Agent shall report all Policy violations to the Staff immediately by telephone, followed by a written notification describing the violation.
- 2.1. The Staff shall report orally, or in writing, all Policy violations immediately to the Senior Investment Officer.
- 3.2. The Senior Investment Officer (SIO) shall immediately report orally, or in writing, any Policy violation verbally to the Chief Investment Officer (CIO), and the Investment Committee (IC).
- 4.3. As a follow-up to the verbal report, the Staff shall prepare a written report of any Policy violation within a time period not exceeding 30 days.
- 5.4. The Chief Investment Officer shall determine the appropriate means of further reporting based on his or her judgment of the magnitude, sensitivity and severity of the violation.
  - a. All Policy violations shall be reported to the Investment Committee as part of a quarterly report agenda item on the Investment Committee's regular agenda. The report shall coincide with the regular quarterly reports of the CalPERS General Pension Consultant.

- b. Depending on the Policy violation, and at the discretion of the Chief Investment Officer, reporting may also be made to the Investment Committee. The report may be made as a separate agenda item or as a portion of the Chief Investment Officer's Report at the next scheduled Investment Committee meeting.
- c. If a Policy violation is to be reported to the Investment Committee, the General Pension consultant shall be asked to provide an opinion as to the impact of the Policy violation to the Program and/or overall fund.

## **VIII. GLOSSARY OF TERMS**

Definitions for key words used in this policy are located in the Fixed Income Glossary of Terms which is included in the System's Master Glossary of Terms.

Approved by the Policy Subcommittee: September 12, 2003

Adopted by the Investment Committee: October 14, 2003

Revised by the Policy Subcommittee: December 10, 2004

Adopted by the Investment Committee: February 14, 2005

Revised by the Policy Subcommittee: June 16, 2006

## APPENDIX I

<b>Equivalent Credit Ratings</b>
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Credit Risk	Moody's*	Standard & Poor's**	Fitch**
<b>INVESTMENT GRADE</b>			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>NON-INVESTMENT GRADE</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	C	C
In default	C	D	D

Source: The Bond Market Association

\* The ratings from Aa to Ca by Moody's may be modified by the addition of a 1,2 or 3 to show relative standing within the category.

\*\* The ratings from AA to CC by Standard and Poor's and Fitch may be modified by the addition of a plus or minus sign to show relative standing within the category.